Volume 64
Issue 3 *Dickinson Law Review - Volume 64, 1959-1960*

3-1-1960

Mr. Nirdlinger, Meet the New Economy

Philip C. Herr II

NOTES

MR. NIRDLINGER, MEET THE NEW ECONOMY *

The Pennsylvania history of the particular phase of trust administration having to do with apportionment between income and principal is exceedingly confused. At first the courts were most concerned with arriving at a distribution as close to exact justice as was humanly possible. This led to the development of the so-called *Pennsylvania Rule of Apportionment.*[1] This rule or set of rules was applied to all trusts prior to 1945. In that year the Pennsylvania Legislature adopted the *Principal and Income Act.*[2] The main objective of this legislation and the subsequent act of 1947 [3] was to simplify the trustee's duties and responsibilities which had theretofore become very confused and complex.[4] In establishing these simpler rules there was an admitted sacrifice of a certain amount of equity in apportionment in favor of convenience. However, the courts have made it very clear that the *Principal and Income Act* applies only to trusts created since 1945, and that any trust created prior to that year must be governed by the old *Pennsylvania Rule of Apportionment.*[5] Needless to say, there are a great many such trusts today, and the application of the old *Rule* to them has proved to be a fertile source of litigation.

The case of *Ketterlinus Estate,*[6] tried before Mr. Justice Klein of the Orphans' Court of Philadelphia in 1955, gave vent to the mounting dissatisfaction of remaindermen and trustees with the decision of *Nirdlinger's Estate,*[7] which was handed down by the Supreme Court of Pennsylvania in 1927 under the old *Pennsylvania Rule. Nirdlinger's Estate* held: "Where the trustee in an ordinary business transaction sells stock, the value of which has been enhanced by accumulated surplus and earnings not declared as a dividend by

* The Editorial Board wishes to express their sincere appreciation to Philip A. Bregy, Esq. for making available to them a copy of the testimony of the *Ketterlinus Estate.*

1 4 Bogert, Trusts and Trustees § 843 (1948 ed.); Earps Appeal, 28 Pa. 368 (1857); Arrott Estate, 383 Pa. 228, 230, 118 A.2d 187, 189 (1955).

2 Pa. Stat. Ann. tit. 20, § 3471 (Supp. 1959), repealed by Pa. Stat. Ann. tit. 20, § 3470 (Supp. 1959).

3 Pa. Stat. Ann. tit. 20, § 3470 (Supp. 1959).

4 Cunningham Estate, 395 Pa. 1, 23, 149 A.2d 72, 84 (1959).

5 *In re* Crawford's Estate, 362 Pa. 458, 67 A.2d 124 (1949); Warden Trust, 382 Pa. 311, 115 A.2d 159 (1955); *In re* Pew's Estate, 362 Pa. 468, 67 A.2d 124 (1949); *In re* Steele's Estate, 377 Pa. 250, 103 A.2d 409 (1954); Arrott Estate, 383 Pa. 228, 118 A.2d 187 (1956).

6 Estate of Elizabeth B. Ketterlinus, dec., In the Orphans' Court of Philadelphia County, No. 2223 of 1952, before Klein, P.J., May 26, 1955.

7 290 Pa. 457, 139 Atl. 200, 56 A.L.R. 1303 (1927).

the corporation," [8] the increment of enhanced value should be distributed to the life tenant. In summary the court said:

> Fifth, *where the trustee sells stock and receives a price greater than the value of the stock at the time of the death of the testator, or at the time it was acquired, the profit being due to an accumulation of income, the court should apportion the proceeds.* Sixth, where the trustee sells stock and receives a price greater than the value of the stock at the time of the death of the testator, or at the time it was acquired, the super value being due to the enhancement or increment of original value through the stock's earning power or what may be termed its "goodwill" or its intrinsic value, this increased value is part of the corpus and belongs to the remaindermen. Seventh, . . . Eighth, where the trustee sells stock at a profit which is due to enhanced market value, and not to accumulated earnings, the increase must be regarded as a capital gain. . . . (Emphasis added.) [9]

The remaindermen of the trust involved in the *Ketterlinus Estate* complained that the rule of *Nirdlinger's Estate* was unrealistic and obsolete in the light of modern corporate accounting practices and the demands which our contemporary economy is placing on business and industry.[10] Unfortunately, from an academic standpoint, *Ketterlinus Estate* was settled by the parties and the orphans' court did not have to pass on the matter. However, Judge Klein indicated by his comments on the record that he did not think it proper for that court to even question such a well established principle.[11]

In the light of these complaints, it might be well to re-examine the rule of *Nirdlinger's Estate* and the reasoning behind it in the atmosphere of our present day economy. It is not the intention of this article to take a stand on the question, but merely to point out its strengths and weaknesses. This will be done by presenting excerpts from the expert testimony introduced at the trial of *Ketterlinus Estate* showing the main arguments against the rule pressed by the remaindermen and how they were countered by the life tenants.

Before turning to the testimony let us first examine the rule of *Nirdlinger's Estate* more closely. Prior to that decision the court had decided two other fundamental cases. The first one was *Earp's Appeal*,[12] which was decided in 1857. This case held that "an extraordinary dividend [in this case stock] paid out of accumulated earnings, presumptively belongs to the life tenant but, if it be shown that the distribution impairs the intact value of the estate, *the court*

---

[8] *Id.* at 469, 139 Atl. at 205.
[9] *Id.* at 478, 139 Atl. at 208.
[10] Notes of testimony, page 179.
[11] Notes of testimony, pages 182 and 265.
[12] 28 Pa. 368 (1857).

will make an apportionment." (Emphasis added.)[13] The second case was *McKeown's Estate*,[14] which was decided sixty-two years later. There it was held: "where the trustee sells stock and the sale in substance effects a distribution [of corporate assets], as in the case of liquidation of the company, the court will disregard the form and treat the sale as a distribution." [15] Later when the Supreme Court of Pennsylvania in *Nirdlinger's Estate* was faced with the problem of whether to classify the sale of stock composing part of the trust corpus as an occasion calling for an apportionment between the life tenant and the remaindermen, it followed the precedent to its logical extension and reasoned:

> [W]hy should the minor liquidation of interest in a corporation by a member thereof in selling his shares of stock therein not be effective as a liquidation which reflects substantially a distribution by the corporation of its accumulated earnings and increment value by reason of that membership? It would seem the reasoning in McKeown's Est., supra, and Earp's App., supra, answers the general question in the affirmative." [16]

The court went further in substantiating its position.

> The testator gave the income of his estate to the life tenants. "Income" may be defined as a gain which proceeds from labor, business or property of any kind, the profits of commerce or business. It includes the return earned by capital stock. It has a broader meaning than the term "dividend"; it includes profits. We said in *Quay's Est.*, 253 Pa. 80, that profits included not only the accumulations of earnings, but the advances or increment in value. It is not necessary to include the latter in the definition. What the testator did was to give to the life tenant all this income. It included all the earnings which his membership in the company or ownership in stock are responsible for, or would bring about, but not the stock's earning power. . . . Therefore every principle of justice demands that the direction of the testator be fulfilled, and that life tenants should receive this income. There is not one single element of justice that speaks for the corpus of the estate to take the earnings. The mere fact that it is earned and retained by the company should not prevent the life tenants from ultimately receiving it unless that receipt does harm to the corpus (intact value) of the estate.[17]

In meeting the argument that the earnings are only distributed by action of the managers of the corporation and therefore should only be distributed to the life tenant at the time such action is taken, the court said:

> Nothing is done that, in the slightest, involves the financial structure of the company. When a trustee sells the stock of a company and the profit repre-

[13] Nirdlinger's Estate, 290 Pa. 457, 478, 139 Atl. 200, 208 (1927).
[14] 263 Pa. 78, 106 Atl. 189 (1919).
[15] Nirdlinger's Estate, 290 Pa. 457, 478, 139 Atl. 200, 208 (1927).
[16] *Id.* at 469, 139 Atl. at 205.
[17] *Id.* at 470, 139 Atl. at 205.

> sents an accumulation of earnings or surplus in addition to intact value, he has physical possession of the income apart from any other consideration. The only screen held up to defeat the life tenants is that the corporation did not formally declare it as a dividend, though it has every such quality, except the name, withheld by the company. In such cases, the sale, in substance and effect, amounts to a distribution, as in the case of liquidation of a corporation. The court will disregard the form, and treat it as a distribution of accumulated interest or earnings, keeping in mind always that the intact value of the corpus shall not be in any way depleted.[18]

The court was by no means unaware of the trust administration problems which its decision would create, but it rather summarily dismissed the question by pointing out the fact that fairly accurate corporate records must be kept for federal tax purposes, and further that the difficulty of administration should not be a bar to the right of the life tenant to income which in all fairness belongs to him.[19]

Perhaps one more thing ought to be said about the rule of *Nirdlinger's Estate.* This concerns the illusory term "intact value"—that value which the court was so ardently trying to preserve for the remaindermen. On its face its meaning seems rather obvious. However, measuring it in dollars and cents is quite a different story. Justice Bell in his dissent in *Cunningham Estate* [20] summarized the Pennsylvania definitions of intact value as follows:

> For a considerable period of time the courts floundered upon a definition of "intact value." Market value was used as intact value in *Earp's Appeal,* 28 Pa. 368; book value was not mentioned. Thereafter the courts sometimes used one, sometimes indiscriminately all, of the following yardsticks for "intact value," viz., intrinsic value, actual value, liquidating value and book value—as if they were synonymous, although actual value, book value and liquidating value are often very different. Then gradually *book* value became recognized (at least prima facie) as "intact value"; and *market value was entirely discarded: . . .*[21]

This explains why the expert witnesses for both parties are so concerned with book value in the testimony which follows.

With this background in mind, let us now turn to the facts of the *Ketterlinus Estate.* In the course of the testimony, it was brought out that the settlor-testatrix, Mrs. Ketterlinus, died August 14, 1930, owning 17,500 shares of Standard Oil of New Jersey stock which were placed in trust. This holding was increased to 18,208 shares by stock dividends in 1938 and 1939. In 1948

[18] *Id.* at 472, 139 Atl. at 206.
[19] *Id.* at 476, 139 Atl. at 207.
[20] 395 Pa. 1, 149 A.2d 72 (1959).
[21] *Id.* at 40, 149 A.2d at 92.

the trustee sold 16,663 of the shares, the proceeds of which were in contention.[22] The life tenants claimed that under the *Rule of Nirdlinger's Estate,* they were entitled to some $200,000 representing the increased market value of the stock due to earnings which had been retained in the company since 1930. The remaindermen, in direct opposition to the *Rule,* took the position that the life tenants should not be entitled to any apportionment merely because there had been a sale of stock by the trustee.

Being cognizant of the pitfalls of generalizations, the arguments of the remaindermen may be broken down into three main categories. They say, first, that the *Rule* is arbitrary and therefore inequitable; second, that the *Rule* violates good trust administration policies; and third, that it disregards contemporary economic conditions and theory. Needless to say, there is a great deal of overlapping among these categories.

In order to substantiate their first argument concerning the arbitrariness of the *Rule,* Mr. Paul C. Wagner, expert witness for the remaindermen, prepared a schedule showing the wide variation in results which the *Rule of Nirdlinger's Estate* can produce dependent solely upon the market price of the stock on the original valuation date when all other factors are held constant. He first considered the actual facts of the case as they occurred, the Ketterlinus estate having been inventoried as of August 14, 1930. Next, he considered the result had Mrs. Ketterlinus died approximately four months before on April 30, 1930. Finally, he considered the result had Mrs. Ketterlinus survived another four months and died on December 17, 1930. The latter two dates represent the high and the low market price of the stock of the Standard Oil Company of New Jersey for the year 1930.

Testimony of Paul C. Wagner:[23]

"I have assumed that the entire holding of 18,208 shares were sold on June 3, 1948, which was a date during the period the sales were made, and

[22] Notes of testimony, page 258.

[23] Paul C. Wagner, Esq. is a graduate of the University of Pennsylvania Law School and was a practicing attorney for about twenty years in the firm of Clark, Wagner, McCarthy and Hebard. At the time of the trial he was Senior Vice-President in the trust department of the Fidelity-Philadelphia Trust Company and a member of the Senior Investment Committee of the Trust Department of that bank and Supervisor of its Apportionment Unit. He was a member of the Advisory Committee to the Sub-Committee on Decedents' Estates Laws of the Joint State Government Commission which was instrumental in the passage of the Principal and Income Act of 1947 and the Fiduciaries Investment Act of 1949. He was a member of the Special Committee of the Trust Division of the Pennsylvania Bankers' Association which drafted the Principal and Income Act of 1945. He was a member of the Committee on Fiduciary Legislation of the Trust Division of the American Bankers' Association for six years and chairman from 1949 to 1952. He was president of the Corporate Fiduciaries Association of Philadelphia from 1950 to 1952, and Chairman of the Trust Division of the Pennsylvania Bankers' Association for the year 1952-1953.

on which date the stock sold at 81½, approximately the average price per share that was obtained for the shares actually sold.

". . . .

"I have assumed the amount of accumulated earnings applicable to this holding of 18,208 shares to have been $452,410. There is very little change in book value of the stock during 1930, and, therefore, for the purpose of comparison, I have used the same book value. The earnings represent the difference in book values between the dates of acquisition and the dates of sales. I have assumed as a book value on the date of acquisition the figure of $46.98 per share, which is one of the book values stated in the stipulation of facts. It is shown on Schedule 1. I have assumed as the book value per share on June 3, 1948, the date of sale, $70 a share, the figure used in Schedule 10 of the stipulation of facts.

"I have not made all of the various adjustments between earnings and capital accounts which have been made in the various calculations shown in the stipulation of facts. I have taken two of the book values which I believe are very close to the book values of the stock established by the annual reports of the company issued at the time. Now, the facts are set forth in the first part of this comparison. I have then made an apportionment of the proceeds of sale under two theories.

"My understanding is that the life tenants claim that they are entitled to the accumulated undistributed earnings applicable to the stock which was sold, regardless of the effect which stock apportionment may have upon the principle of the trust. Now, under this theory the life tenants in each of the three examples used would receive $452,410, which is the amount of accumulated earnings. It is true that if you made a very careful analysis of the company's statement during the year 1930, there might be slight variations in the book value of this stock on the three dates in 1930 which I have assumed as the date of acquisition, but I do not believe they would affect the general result or the implications of these two comparisons.

"After distributing $452,410, which, under this theory comes out of the proceeds of sale first, there is left $1,031,542, the balance of the sale price, the total sale price having been $1,483,952. Under that theory, in the Ketterlinus Estate, if the entire holding had been sold, principal would have suffered a loss of $169,000, taking into consideration the inventory value of the stock. If Mrs. Ketterlinus had died four months previous, on April 30th, then the loss to capital would have been $438,000. On the other hand, if she had died four months later, on December 17, 1930, principal would have had a gain of

$261,000. That is the result under the theory of the life tenants, as I understand it. Remember, in this case the life tenants get exactly the same amount.

"There is another theory of apportionment which has been advanced, that is, that although the life tenants are entitled to the accumulated undistributed earnings applicable to the stock which has been sold, distribution to the life tenants is limited in dollars to the amount of actual profit resulting from the sale of the holdings. Under such a theory, using the same cases, the income beneficiaries in the *Ketterlinus* case would receive $283,015 with no gain or loss whatever in principal. In other words, the income beneficiaries have received all of the profit realized by the trust. If the date of death had been April 30, then, the income beneficiaries would receive $13,952, and again there would be no gain or loss in principal. However if the date of death had been December 17th, 1930, the income beneficiaries would receive $452,410, that is, the entire amount of the accumulated earnings; whereas the gain in principal account would be $261,000.

BY THE COURT:

Q. "Suppose Mrs. Ketterlinus had died intestate, leaving a son to survive her, on one of the three dates you selected. The son would have gotten more or less, depending on the value of the stock upon the date of her death; is that right?

A. "Certainly.

Q. "Suppose there had been no continuing trust and the stock was sold and distributed promptly. The beneficiaries would have received reduced or increased sums depending upon the market price of the security at the time?

A. "That is true, but it seems to me that in dealing with the trust some consideration must be given to preserving the value of the trust as it started.

Q. "One of the conclusions which must be drawn from your testimony at this point is that perhaps there is a great deal of common sense in the old Rule. Here you say that by the fortuitous fact of her dying on a certain date, the value of the estate can fluctuate by very large sums of money.

A. "Yes, but in this case we are considering how much is left for the remaindermen in 1948 out of an estate which started in 1930. As shown by these examples, in 1948 the remaindermen of an estate which started in December, 1930, would receive, under the theory propounded by the life tenants, as I understand it, a capital gain of $261,000, where as the remaindermen of an estate which started eight months earlier would suffer a principal loss of $438,000.

Q. "From that I draw the conclusion that an investment in common stocks at best is treacherous and uncertain and that over the years, in long, continuing trusts, the corpus of the trust can suffer very severe losses by reason of a fluctuation in the value of stocks.

A. "I don't know whether that should be a matter of comment or not. The comment that I make is that any trust invested in common stocks is going to have considerable variations in principal value. The variations in principal value do not necessarily indicate the variations in intrinsic value over a long period of time, but when you are apportioning the proceeds of sale you are apportioning an amount in dollars, which is entirely dependent upon the market at the time that you make the sale. Therefore, the dollars that you have are definitely dependent upon the market, and if you are going to distribute the proceeds according to a theory and formula which pays no attention whatever to market value, then, I insist that there is a certain lack of reality in the approach to the problem.

". . . .

"I would like to present an illustration of the differences which may result from the sale of the same stock on different dates but at exactly the same price. These are for whatever use may be made of them in presenting this problem. All book values and market prices have been carefully calculated for the respective dates by our Apportionment Unit.

"I assume this case: A trustee purchased 100 shares of Standard Oil of New Jersey common stock on December 31, 1931, at 28 per share at a total cost of $2,800. The book value of the stock on that date was $48.15 a share, so that the holding had a book or intact value of $4,815. The shares were subsequently sold at $70 a share resulting in a capital gain of $4,200.

"Now, the first case (a) if this investment were sold on December 30, 1936, at a price of 70, which was the market, when the book value was $43.81 per share. There was no accumulation of earnings, the book value at date of sale being less than the intact value, and consequently, no award is made to income account.

"(b) If sold on January 7, 1946, at the price of 70 when the book value was $57.48 per share, the earnings accumulation was $9.33 per share, or a total of $933 for 100 shares. Income would therefore be entitled to $933, and the balance of the gain, amounting to $3,267, would remain in principal account.

"(c) If the sale was consumated on July 17, 1950, when the book value is $81.62 a share, the earnings accumulation would have been $33.47 per share, or a total of $3,347. Under these conditions income account would be awarded $3,347 out of the total gain of $4,200, and only $853 would be retained in principal." [24]

The second line of assault on the *Rule of Nirdlinger's Estate* pressed by the remaindermen was that it violated good administration policies. After establishing that common stocks are a good form of trust investment, the attack became two-pronged. First, it was contended the *Rule* tends to annul the purpose and principle of diversification in investing the corpus; and second, since apportionment is controlled by the sale of stock, the trustee may be placed in the awkward position of being pressured to sell or refrain from selling in spite of his best investment judgment.

Let us first consider what was said by the trust expert for the remaindermen about the advisability of investing trust funds in common stock.

Testimony of Paul C. Wagner:

"I think it is difficult to approach the problem of apportionment without some understanding of the purpose of trusts and the policies which have affected investments. Trusts as originally established consisted primarily, if not exclusively, of real estate, and the objective of the trustee was to preserve the real estate or the trust res, as it is called, in the form in which it was received by the trustee, to administer the trust so as to produce the maximum amount of income for the life tenant, and then to pass the property on to the remaindermen.

"As time went on, it happened more frequently that the real estate was sold and converted into pounds or dollars; or the trust, when established, consisted of securities or money rather than real estate. Then, the trustee conceived his duty to preserve, not the piece of real estate which he had received, but the securities or the amount of money which he had received. In other words, the trustee considered it to be his duty to preserve the dollar value of the principal which he had received, and he was satisfied with his performance if he was able to turn over to the remaindermen securities or

[24] Notes of testimony, pages 258 to 267.

properties which had the same dollar value as that of the principal which he originally received. It was this concept of trust administration which was in force when trusts were first established and administered in this country and which, with some minor modifications in various parts of the country, existed until approximately 20 or 25 years ago.

"Investment in common stocks, unless specifically authorized in the instrument, was regarded with suspicion in most jurisdictions. Massachusetts and a few States which followed the Massachusetts Prudent Man Investment Rule were the exceptions. However, it had been recognized prior to the period I just referred to that trusts could be invested safely in other securities than Government, State and Municipal bonds and first mortgages and ground rents. Pennsylvania removed the constitutional prohibition against investment in corporate bonds, and a statute was passed making such bonds legal for trust funds, but requiring compliance with very complicated formulae.

". . . .

"During the fourth decade of this century the tremendous losses which had occurred not only in trusts, but in private portfolios, through defaulted mortgages and failures of corporations which had outstanding both bonds and debentures, resulted in a reconsideration of trust investment policy.

"It was recognized that equities, if properly selected, could well be as good a trust investment as fixed income securities. The Courts of this state finally decided in 1938 that the words "securities" and "investments" when used in trust instruments, included common stocks.

"The low rates of interest received on corporate securities during the early 1940's practically forced trustees to look for investments which would in some degree maintain the income in dollars which had been received in the 1920's, when interest rates were at a much higher level. I have before me a copy of a report by the Trust Investment Study Committee of the Trust Division of the New York State Banker's Association prepared in 1949 for use in connection with proposed legislation to be submitted to the New York Legislature, authorizing common stocks as a legal investment for trust funds.

". . . .

"On page 91 of that report appears a table designated 'Table 10', which compares, among other things, Standard and Poor's index of high grade bond yields and the average annual yield of Standard and Poor's Composite Ninety Common Stocks Index for the years 1926 to 1948 inclusive.

". . . .

"That index shows that in 1926 the average income from high grade corporate bonds was 4.7%. It went below 4% in 1935, stayed in the 3% range until 1940, and then below 3% and did not get above 3% between 1940 and 1948.

"The composite common stock index started at 5.06% in 1926 and got as high as 7.68% in 1932. It was between 6 and 7% in 1941 and 1942 and was 5.53% in 1948.

"The need for income became much greater after the second World War, with the rapid rise in the cost of living. Changed economic and social conditions made it necessary to secure for life tenants an income which would enable them to live. Trustees came to the conclusion that although a trust was established to administer principal with care and due regard for safety, an equally important objective was the preservation of purchasing power for the life tenant through the increase of the dollar amount of income distributed. This could be done only by an investment in equities in the expectation that a dynamic and expanding economy would result in increased dividends and therefore increased income for the beneficiary, and a resultant increase in the market value of the principal of the fund. In other words, every effort was made to obtain increased dollar income for the life tenant, to compensate, in part at least, for the increased cost of living, and also to pass on to the remaindermen a principal fund which would continue to give the remaindermen a similar increase in income." [25]

Having recognized that common stocks make a good form of trust investment, the remaindermen point out that in the light of their fluctuating value the trustee should diversify his holdings.

Testimony of F. W. Elliott Farr: [26]

"I think I would like to dispose, first of all, if I may, of the fact that in investing in common stocks we feel that the principle of diversification is

[25] Notes of testimony, pages 239 to 244. Mr. Wagner then gave illustrations of the recent trend in trust funds to acquire stocks to increase their yield.

[26] Mr. F. W. Elliott Farr holds a Master's Degree from Harvard Business School of Administration. At the time of the trial he was Vice-President of the Girard Trust-Corn Exchange Bank (Philadelphia) in charge of investment analysis and research and a member of the Officers' Committee on trust investments of that bank. He served as a financial analyst for the Navy Department during World War II. He was a member of the Investment Faculty of the Graduate School of Banking at Rutgers at the time of the trial and was active in the Financial Analysts of Philadelphia and a member of the Corporate Information Committee of the National Federation of Financial Analysts Societies. At that time he was also serving on the Apportionment Committee of the Corporate Fiduciary Association.

basically important, and, therefore, the payment of profits of one transaction has a tendency to violate the theory of diversification in investment policies.

". . . .

"[W]e, in investing in common stocks as trustees, spread the risk, recognizing a higher degree of risk in such stocks than in other investments made by trustees. The basic reason for diversification is to offset the possibility of losses with gains. To the extent that the apportionment of gains syphons off the profits and lets the loss ride, we feel it is unsound from that point of view.

BY THE COURT:

Q. "Do you mean to say that you diversify your trust portfolios for the reason you just gave? I thought that the basic reason was that in case there was a catastrophe in any particular industry, a trust would not be completely wiped out, as the investments would be spread over various areas of the economy?

A. "That is correct. We do that so that the gains we hope to make will offset any losses which may occur in other areas of investment. The point I was making was even if one successfully does that and if the gains are not used to offset the losses, in practice the principle of diversification falls down.

Q. "You come rather close to speculating with trust funds.

A. "We try to recognize that investments in common stocks, while not speculation, carry a great element of risk, and the element of speculation is removed from it the same way as an insurance company removes itself from speculation by offsetting losses against gains in a pattern which will give a good prospect of permitting gains to exceed the losses. It is not our desire or hope to invest in any way so as to cause a loss, but it is a possibility which may occur." [27]

Testimony of Paul C. Wagner:

"My third reason [for the abandonment of the rule in *Nirdlinger's Estate*] is that I am of the opinion that apportionment does not under any formula which has heretofore been adopted or suggested result in a fair and equitable distribution to principal and income of their proper proportionate shares of appreciation or depreciation. The principle of apportionment overlooks the fact that an investment portfolio must be administered as a whole and not

[27] Notes of testimony, pages 208 to 209.

as a number of individual and unrelated items, if an overall satisfactory result is to be obtained. The modern portfolio is diversified because the trustee knows that losses are inevitable. To distribute the profits resulting from the sales of common stocks without making adequate provision for recouping losses seems obviously unfair to the remaindermen. To distribute to the income beneficiaries a portion of the proceeds of such sales, as distinguished from the profits, regardless of whether or not a profit has been realized, seems to be obviously more unfair to the remaindermen. The present Rule and its application in practice is likely to result in feast or famine for the life tenant. The average testator, I believe, wants the life tenant beneficiary to enjoy a reasonably steady income. I should like to note here that the impracticability of apportioning the proceeds of sales of stocks within a reasonable time after the sale takes place, to which I will refer later, results in large distributions of such apportioned proceeds at one time, that is, when an account is filed, and in many cases not to the life tenant but to his estate." [28]

Turning now to the argument that the *Rule* places the trustee in the awkward position of having a certain amount of control over the distributions to the life tenant and remaindermen, the experts said:

Testimony of Brandon Barringer: [29]

"It [the *Rule of Nirdlinger's Estate*] is extremely unfair to a trustee because it puts him in the position of discriminating between life tenant and remaindermen. He should sell a stock only when in his judgment it is above the prospective value of the future dividends or when there is an opportunity of switching into what seems to be a more attractive investment. The rule adds to the problems necessarily involved in this decision a duty to consider from the point of view of the life tenant whether there are a substantial amount of undistributed earnings which should be captured for the life tenant by the sale of the stock at a profit. On the other hand, in this very case, the sale of the stock is bound, under the rule, to result in an injustice to the remaindermen through the distribution of part of the corpus of the trust which would not have to be distributed if the sale weren't made. From an experience of nearly thirty years in administering trust estates, I can think of no way of not doing

[28] Notes of testimony, pages 251 to 252.

[29] Mr. Brandon Barringer at the time of the trial was Treasurer of Curtis Publishing Company. In 1921 he was employed in the Statistical Department which handled analysis of trust investments of The Pennsylvania Company for Banking and Trusts in Philadelphia. In 1923 he was placed in charge of that work. In 1933 he became a Vice-President of the bank and remained in that position until 1949. During that time he was in charge of trust investments. He has been a past director of some twenty corporations including Lehigh Valley Railroad, the Curtis Publishing Company, Old Ben Coal Corporation, Cambria Iron and the Wellington Fund.

an injustice to one or the other of the beneficiaries of a trust fund while this rule exists. All a trustee can do, it seems to me, is to try to balance the injustices by occasionally selling stocks so as to make an additional distribution to the life tenant and on other occasions retaining them because the net value after such distribution and the capital gains tax would in his judgment be less than the stock is intrinsically worth. When life tenants understand their apparent rights in the matter and insist that a trustee sell, or continue to hold the stock at his peril, his position becomes even more difficult.

"Actually, I feel most trustees make investment decisions entirely ignoring possible apportionments. I have been a trustee of my father's estate for over 25 years. During this period, which has covered two court accountings and the taking of many common stock profits, I have never even considered the apportionment of such profits. I think this may be true of most trustees." [30]

Testimony of F. W. Elliott Farr:

"The capriciousness of the application, of course, is based upon the fact that if the investment is held until the culmination of the trust, no occasion arises for apportionment. It would seem, therefore, that the apportionment of capital gains has nothing whatever to do with the investment itself but is based upon some specific action which is taken by the trustee. I think I can testify from my own experience that I have never known a professional trustee to sell a security except for investment reasons unless, of course, it becomes necessary to raise money for some special purpose such as distribution or the payment of taxes. On the other hand, a trustee has a duty to act impartially between the interests of the life tenants and their remaindermen. These duties would be likely to conflict if a proposed sale were to be the occasion for apportionment. Investment or capital gains tax consideration might indicate a favorable sale of the stock. It greatly increases the responsibilities and difficulties of proper trust administration if such action also becomes, in effect, the exercise of a "power of appointment", by which the trustee can exercise or direct the payment of a portion of the proceeds of sale to the life tenants. I think this poses a very serious problem for the co-trustee who is also a life tenant of the estate in which he is co-trustee. He would find himself in a rather difficult position, because he would have to consider whether his motives for suggestion or acquiescing in a sale of a security are based upon personal considerations or considerations solely for the benefit of the trust—both present and future beneficiaries considered. It seems to me that the interests of life

[30] Notes of testimony, pages 195 to 197.

tenants and remaindermen should not depend upon the decisions of a trustee made for entirely alien considerations having to do with relative investment values." [31]

Testimony of Paul C. Wagner:

"Since there is no apportionment of the market value of common stocks held at termination of a trust between the life tenants or the estates of life tenants who receive the income at the time of termination, and the remaindermen, it is wholly in the power of the trustee to retain securities until termination and thereby deprive the life tenant of amounts which might be apportionable to income on sale, to the advantage of the remaindermen. On the other hand, pressure can be and has been exerted by life tenants to induce the trustee to sell common stocks for the purpose of apportioning the proceeds. A trustee who has suffered losses may be reluctant to sell a stock which has shown considerable appreciation, because of his desire to recoup previous principal losses. It may well be that it would be to the best interest of the portfolio as a whole that the stock in question should be sold. However, the fact that an apportionment may be made may have some influence. I will refer to that later. In many instances stocks have been sold at a profit in order that losses sustained during the same or the immediately preceding tax years are not lost for capital gains tax purposes. In many such cases the stocks which have been sold at a profit are repurchased at once at the same price for which they were sold. In such case, although the particular holding remains the same, the principal of the trust is reduced by such amounts as may be apportionable to the life tenants out of the proceeds of sale. In my opinion, a trustee should be able to decide whether a stock should be sold or retained in accordance with sound investment considerations only without being influenced directly or indirectly, consciously or subconsciously, by the unknown counsequences of possible apportionment. I agree with what was said here yesterday that a trustee makes every attempt to sell securities for investment reasons only and without considering the matter of apportionment. I also believe that it is almost impossible not to be influenced to some extent subconsciously by the fact of possible apportionment." [32]

The third category in which the remaindermen's arguments may be placed is that the *Rule in Nirdlinger's Estate* does not take cognizance of modern economic conditions and theory. The basic contention is that the balance

---

[31] Notes of testimony, pages 203 to 204.
[32] Notes of testimony, pages 250 to 251.

sheet figures on which the *Rule* bases apportionment do not reflect the true value of the assets or the value of the investor's share in the business. The expert accounting witness for the remaindermen said:

Testimony of Robert W. Williams:[33]

Q. "I want to read to you what the Supreme Court of Pennsylvania said in the decision in *Nirdlinger's Estate* in 1927. I would like you to comment on this passage, from an accountant's point of view: 'But it is said that it would be extremely difficult to prove how much of the price realized in fact represented income. This should not be difficult at this time. The United States Government requires a fairly regular set of books to be kept for income return. Therein depreciation, renewals, reserves, replacements, and all the various charges are kept. There is the fixed fact, the amount realized from the sale of the stock. There is the amount set apart as earnings, divided into dividends paid and undivided as surplus which may be found in the "profit and loss" account. This may not be conclusive or the only method, but it is an illustration.'[34]

". . . .

A. "In the case of a small private corporation incorporated individual or partnership—what I would perhaps refer to as an incorporated pocketbook—there might be some significance in that statement as applying to the circumstances before the Court in that case.

"But it seems to me wholly unrealistic to extend that simple case in application to the financial affairs of a great corporation. We all know that taxation and accounting for the purpose of determining taxable income are based upon rules, in many cases extremely arbitrary, against which business men and accountants have protested for years. There are many differences between the taxable income for any period of a business and its book income or certainly its income in the economic sense.

". . . .

Q. "Further in connection with the passage which I read to you, does a balance sheet reflect the true or actual or intrinsic worth of corporate assets?

A. "That concept is a fallacy which I would like to do my best here to dispell. Let me read into the record a list of the purposes of financial ac-

---

[33] Mr. Robert W. Williams is a certified public accountant. At the time of the trial he had been associated with the firm of Price, Waterhouse and Company for 34 years and was a senior partner.

[34] See note 20 *supra*.

counts: (1) A report of stewardship; (2) A basis for fiscal policy; (3) To determine the legality of dividends; (4) As a guide to wise dividend action; (5) As a basis for obtaining credit; (6) As information for prospective investors; (7) As a guide to the value of investments already made; (8) As an aid to Government supervision; (9) As a basis for price or rate regulation; (10) As a basis for taxation.

"In none of these purposes can we include the concept that a balance sheet or financial statement of a great public company indicated whether the value of individual assets of the company or the combined total aggregate value of its assets or the value of the investors' shares in the business." [35]

At this point the expert witness for the life tenants answered:

Testimony of Edward Hopkinson, Jr., Esq.[36]

"I have examined the published annual reports of Standard Oil of New Jersey for the years 1930 to 1951, which are part of the record in this case and have noted that the reports for the years 1934 to 1951, both inclusive, except for the year 1944, are certified by Price Waterhouse and Company, a leading firm of certified public accountants. Mr. Williams, one of the earlier witnesses in this case, has testified that he is a member of that firm. For convenience of reference, I have copied the accountants' certificate contained in the annual report for 1951 and present it herewith.

" . . . .

[35] Notes of testimony, pages 284 to 288.

[36] Edward Hopkinson, Jr., Esq. is a graduate of the University of Pennsylvania and the University of Pennsylvania Law School. He was a practicing attorney for 16 years in the firm of Dickson, Beitler & McCouch, now Drinker, Biddle & Reath. In the latter part of that practice he specialized in corporate finance and underwriting and distribution of securities. In 1926 he became a partner of Drexel & Co. which later affiliated with J. P. Morgan & Co. At the time of the trial he was a partner in the firm Drexel & Co. which was a member of the New York and Philadelphia-Baltimore Stock Exchanges, an associate member of the American Stock Exchange and registered under the Investment Advisors Act. He was President of the Investment Bankers Association of America in 1947 and was Vice-President and member of its Board of Governors for several terms. He was a member of the Board of Governors of the New York Stock Exchange from 1951 to 1954. He had been a Director of the United Corporation, Public Service Corporation of New Jersey, The United Gas Improvement Company, Philadelphia Electric Company, Riverside Metal Company, Bank of North America & Trust Company, Germantown Trust Company, Girard Trust Company, and Reading Company. At the time of the trial he was a Director and Member of the Finance Committee, Insurance Company of North America, The Philadelphia Saving Fund Society, The Pennsylvania Fire Insurance Company, The Transportation Mutual Insurance Company, Westinghouse Electric Corporation, a Trustee and Chairman of the Investment Committee of the University of Pennsylvania, a Trustee and Member of the Finance Committee of the Free Library of Philadelphia and the Overbrook School for the Blind, and Director of Baldwin-Lima-Hamilton Corporation, Philadelphia Transportation Company, Rohm & Haas Company, Collins & Aikman Corporation, Baldwin Securities Corporation and The Midvale Company. Mr. Hopkinson has also taken part in a number of reorganizations in the United States Courts and before the Securities and Exchange Commission, having acted as financial advisor and/or expert financial witness to various utility companies in such proceedings.

"The other annual reports of the Company which were certified by Price Waterhouse and Company contain substantially the same form of certification. In light of these certifications I cannot see how anyone can dispute that the aforesaid financial statements present fairly the financial position of Standard Oil Company of New Jersey and its subsidiaries consolidated and the results of their operations for the particular years.

"Furthermore, the determination of earnings is, within the limitations imposed by recognized practices, a management function. It is the duty and the function of the corporate directors to determine earnings, and the corporate books certified by reputable accountants are, therefore, accepted as the best evidence of the earnings of a corporation." [37]

Having made the above general observations, the remaindermen then turn their sights on two principal targets. First, they say that the "earned surplus" reported by a corporation on its balance sheet is not a true measure of its economic gain and therefore not distributable because of the decline in the purchasing power of the dollar and the effect of obsolescence. Second, assuming *arguendo* that the "earned surplus" does bear some relation to economic gain, the market price paid or received on the purchase or sale of stock bears little or no relation to the book value, or more specifically, the increase in book value due to the retention of earnings in the business.

In regard to the effect of the decline in the purchasing power of the dollar on the shares of the beneficiaries when the *Rule in Nirdlinger's Estate* is applied, the experts for the remaindermen said:

Testimony of Robert W. Williams:

"First let me give you three simply stated postulates of corporate accounting. One is that a gain or income is not realized until the sale is made. Manufactured goods are carried at the cost of production until the sale is made.

"The second basic postulate is that of continuity. The corporate institution is regarded as continuing. Its financial statements are based on the postulate that it will go on for an indefinitely long period.

"The third is the postulate I would like to question but which has so far been accepted. It is that in financial accounting the changing value of the dollar may be properly ignored. That postulate I would like subsequently to challenge.

[37] Notes of testimony, pages 319 to 320.

Q. "You say you would like to challenge it. Do you recognize that there is a fallacy in the basic postulates which you just enumerated with respect to how a balance sheet is made up?

A. "The art of accounting has developed recently in terms of decades and generations. It dates back to less than a hundred years, during most of which period of time—or, at least, until the most recent decade—the value—and I use 'value' advisedly—of the dollar did not rapidly change. But with the developments following the last World War the pace of acceleration of the devaluation of all currencies reached a point where many accountants feel that accounting statements are unsatisfactory unless they do make allowance or give account to the depreciation in the purchasing power of the dollar. That is most important in the understanding of financial statements of heavy industry, such as the utilities and the great manufacturing institutions with a large amount invested in plants. That would include the oil companies. The dollar cost of plant facilities made in 1930 dollars is still being charged periodically to income account in terms of those 1930 dollars; whereas, all the other elements in the income account are stated in terms of 1950 dollars or 1948 dollars—we will later discuss the year 1948—so that the income is over-stated in economic terms. The accumulated retained earnings are substantially overstated. There is a mixture of different kinds of dollars and there is an insufficient charge or deduction from accumulated earnings to measure the true economic exhaustion of the plant assets consumed in the process of manufacturing.

Q. "You said that some accountants feel that the decline of the purchasing power of the dollar should be recognized in the construction of a balance sheet. Are you such an accountant?

A. "I do believe that. I believe the periodic income statements should include a charge which would increase the depreciation charge in terms of historical dollars—would step that up to represent the measure of exhaustion, which is depreciation of the plant, during the year in terms of current dollars, or make the translation in all cases from historical dollars to current dollars by application of a generally accepted price index to the costs when they were expended.

Q. "Have you made recommendations as to how that technique should be used by accountants?

A. "Yes. It would involve a charge to income, as I have said, in excess of that which is computed on the conventional historical dollar cost of the assets.

Q. "Is that practice which you recommend generally followed in the profession?

A. "It has not been followed. We have been unable to sell it to business men or the accounting profession as a whole. Business men, I believe, like to see these fancy, large figures of income, even though they know they are unrealistic and even though they know the accumulated, undistributed earnings cannot be distributed because they must be maintained in the business to keep it competitive and to allow it to stay in business.

Q. "Do I understand you to say that there is disagreement between yourself, for example, and other accountants as to the technique, but that there is no disagreement between yourself and other accountants as to the fact that present technique does result in a substantial overstatement of undistributed earnings?

A. "We all agree that there is a substantial overstatement of undistributed earnings. That leads me to the more serious question of whether the undistributed earnings shown in any corporation's statement can ever be distributed to any one. We believe that they cannot be, and the business man believes that they cannot be. They form part of the business.

Q. "Would you elaborate on that last comment? Why do you feel that reinvested earnings cannot be distributed?

A. "Because they are locked up in the business.

Q. "In what sense are they locked up?

A. "They are invested in plants or applied to the payment of debts. We can illustrate the point by looking at the position of Standard Oil Company of New Jersey. At the end of 1948 it had acquired the funds with which it was doing business from three sources: Capital, debt, and re-invested income. Of the re-invested income only one-sixth was held in the form of working capital and it is only out of working capital that dividends can be paid.

". . . .

Q. "Mr. Williams, we have shown you a stipulation which has been entered into by the parties to this litigation and which reflects the market value of the Standard Oil of New Jersey stock when it came into the Ketterlinus Trust in 1930, and it also shows the proceeds realized from the sale of that stock in 1948. Have you applied the factor of the purchasing power of the dollar, which you mentioned a moment ago in your testimony, to those figures?

A. "Yes. It seems to me that in 1948, when the sale of this block of shares was made, the trustee realized so many dollars in 1948 dollar figures, but in order properly to compare this unadjusted dollar with the intrinsic value of this block when it came into possession of the trustee, it would be necessary to reduce the dollar received in 1948 by a factor of .69. In other words, the proceeds of sale of 1948 actually realized, in purchasing power, a smaller amount than the value of this block when it first came into the trust. There was an actual loss in capital value during the 18-year period.

". . . .

"As I made this up, the block of shares sold in 1948 had a basis—that is, the 1930 value of these shares was something like $1,133,000. The proceeds which are in the stipulation are $1,359,000, indicating an apparent gain of $226,000; but if we write down these 1948 dollars to the same wave length as the 1930 dollars which came into the trust, we find a proper figure to compare with the 1930 basis is $944,000.

Q. "So that in terms of purchasing power the proceeds of the sale in 1948 were less than the inventory value in 1930?

A. "Yes. In carrying out its duties to preserve the principal, the trustee, by reason of its decision to sell, sustained a loss in economic terms." [38]

In regard to the effect of obsolescence on the *Rule of Nirdlinger's Estate,* the expert for the remaindermen said:

Testimony of F. W. Elliott Farr:

"The 'increase in book value' theory in determining the rights of principal and income seems to me to depend upon whether so called retained earnings really represent true earnings, withheld from stockholders. Under conditions of very gradual technological change in industry and of a stable price level, some theoretical validity might be assigned to the book value theory. Under conditions as they have existed in the last three decades, however, a reliance upon book value seems to give a completely false picture. No manufacturing enterprise which distributes all of its reported net earnings as dividends is likely to retain the value of its stock at a constant or increasing level for very long. A considerable plow-back of book net earnings is required to maintain the competitive position of an enterprise even under a period of stable price

[38] Notes of testimony, pages 289 to 297.

conditions if significant technological improvements are taking place in industrial practice.

". . . .

"Even if the price level for machinery does not change, the new machine replacing the old machine will probably be more expensive, because it will be a more modern machine and will have more expensive control devices of various kinds. Obviously, the replacement of a 20 year old machine with an identical machine would merely perpetuate obsolescence.

"You mentioned a change in the price level. The situation which I have just discussed would be greatly complicated by a rising price level. Over the last two decades the cost of replacing facilities acquired in earlier years has greatly exceeded the amount charged for bookkeeping purposes as depreciation. An example of this is to be found in the steel industry.

". . . .

"I can state this from my own familiarity with the balance sheets of steel companies and the statistical work I have done. The present stated value of steel capacity on the books of American steel corporations is of the order of 50 dollars a ton integrated capacity. The cost of building equivalent new capacity or of replacing capacity is of the order of $250 to $300 a ton. Consequently, it is necessary for a steel corporation to retain large sums of money reported to be earnings for stockholders and for tax purposes in order to have adequate funds to maintain productive facilities intact as older facilities are retired and replaced.

"A similar situation exists in the oil industry, particularly the part of the industry which has large holdings of crude reserves which have been acquired over a long period of years, many of them acquired at low prices, first, because the price level at the time they were developed was lower, and, secondly, in recent years it has been necessary to expand geographically and the average depth of wells drilled has increased very greatly, probably two to three times in the last twenty years. As oil corporations have been drawing down their low cost oil reserves they have been replacing those reserves with new reserves acquired at high cost. This has meant that a part of the increase in the book value of many oil stocks may have been illusory and may have represented a swap of reserves acquired at low prices for reserves acquired at high prices.

"I would like to give the theoretical case of a taxi driver in 1942 who buys a taxi for $1,000, depreciated it over a ten year period, and in 1952 took his

$1,000 of accumulated depreciation, representing the original cost of his cab, to buy a new cab and finds that it will only defray one-half of the cost of the cab. It seems clear to me that the taxi-cab owner has been under-depreciating his cab in terms of real values by 50%. I think that the same situation applies in a much more complicated way to practically every industrial and manufacturing corporation.

". . . .

"I do know from my own discussions that this problem of depreciation is one which is troubling a great many corporations. I think it is perfectly clear that surplus retained out of the earnings of most American corporations today is not surplus in the sense that it is thought of as a legal concept. It represents monies spent in effect to protect an existing investment, and if not spent, the existing investment would almost necessarily have declined in value." [39]

To this particular line of argument the income beneficiaries also had an answer.

Testimony of Edward Hopkinson, Jr., Esq.:

Q. "Is this 'gradual depreciation in the purchasing power of the dollar' a new economic factor which was not in effect at the time of the decision of the Supreme Court in the *Nirdlinger* case in 1927?

A. "No, certainly not. This phenomenon has been operating for many, many years and has long been recognized. For example, the 'Index of Change in Prices of Goods and Services Purchased by City-Wage Earners and Clerical-Worker Families to Maintain Their Level of Living', published by the United States Bureau of Labor Statistics goes back to the year 1820. This is a companion index to the Consumer Price Index prepared by the United States Bureau of Labor Statistics referred to by Mr. Wagner at page 246 of the notes of testimony. It shows that the value of the dollar for the years 1820 to 1952 (annual averages), expressed in cents based upon the value of the 1947-1949 dollar, was as shown on an exhibit which I have prepared for convenience of reference.

". . . .

Q. "Although the Index which you have just mentioned definitely shows an inflationary trend over a long period, do the cycles to which our business

[39] Notes of testimony, pages 211 to 215.

economy is subject cause violent fluctuations in the purchasing power of the dollar which are reflected in the statistics to which you have just testified?

A. "Yes. Wars, rapid expansion of business over a short period, business recessions, changes in governmental fiscal policies, as well as industry-wide wage and salary adjustment, obviously have an effect upon the purchasing power of the dollar. For example, the Civil War period from 1860 to 1865 reflects a drop in the purchasing value of the dollar from 389.1 in 1860 to 232.0 in 1865, while the depression period which followed that war is reflected in an increase in the purchasing value of the dollar to 261.1 in 1870. World War I is reflected in the figures in the decrease from 230.8 in 1915 to 116.7 in 1920. The depression of the early 1930's is reflected in the increase in the purchasing power of the dollar from 136.4 in 1929 to 181.1 in 1933. World War II is reflected in the figures in decrease of the purchasing power of the dollar from 168.2 in 1939 to 120.3 in 1946. Further erosion is shown in the annual figures since.

Q. "Mr. Hopkinson, do you know of any corporation that keeps its books of account on any basis other than that of simple dollar figures without regard to the current purchasing value of the dollar?

A. "Although the gradual change in the economic value of the dollar over a long period has been recognized by the management of corporations as well as economists for many years past, I do not know of any corporation that keeps its accounting records on any basis other than that of simple dollar figures without regard to the purchasing power of the dollar at the time the corporate statements are published. No business corporation to my knowledge uses any other accounting method than that based on simple dollar figures. The factors which would prevent the entry of the philosophy of the value of the dollar into accounting records are (1) the desirability of keeping books of account as nearly as may be in accordance with Federal and State tax statutes and the necessity of following the rules and regulations promulgated by Federal and State regulatory bodies to the extent applicable, and (2) the practical difficulty of determining any appropriate adjustment which would reflect the upward and downward fluctuations that occur over short periods as contrasted with the general inflationary trend that has existed over long periods. Further, the Index published by the Bureau of Labor Statistics may in itself be subject to criticism from time to time as to whether it properly reflects the purchasing value of the dollar. For example, the Bureau itself in January, 1953, revised its basis of computing the purchasing value of the dollar because of so-called changes in the standard of living and the purchasing habits of the typical families selected by the Bureau as the basis for computing its calculations.

Q. "You will recall that Mr. Farr testified, at page 212 of the notes of testimony, 'Over the last two decades the cost of replacing facilities acquired in earlier years has gradually exceeded the amount charged for bookkeeping purposes as depreciation.' Is Mr. Farr's statement true only as to the last two decades?

A. "Mr. Farr's statement is not only true as to the last two decades but has also been true over a much longer period in that there has been a generally rising price level for many years and that companies have always found in periods of rising price levels that the cost of replacement of fixed property necessarily exceeds the amount charged for bookkeeping purposes as to depreciation of property acquired at a generally lower price level during prior years. Likewise, obsolescence operates independently of ordinary depreciation, and may cause replacement of machinery prior to the time when it is worn out, with new and even more expensive machinery. I would say that I know of no corporate precedent for the depreciation of plant on a replacement cost basis." [40]

The second target of the remaindermen, in trying to demonstrate that the *Rule of Nirdlinger's Estate* is not based on good economic theory, was that book value had little or no comparative value to the actual price paid or received by a trustee in the sale or purchase of stock. Going still farther, they maintained that unlike the basic assumption of the *Nirdlinger Rule,* an increase in book value due to the retention of earnings is not necessarily reflected by or related to an increase in market value of the stock. On this basis they argued that there was no logical reason why the income beneficiaries were entitled to an apportionment of the proceeds of a sale based on any increase in the book value due to retained earnings.

Testimony of F. W. Elliott Farr:

Q. "While we are on that point, I wonder if you will comment upon the relationship, if there is a relationship, between the book value of the investments a trustee makes when he buys a share of a corporation and the market value of a share?

---

[40] Notes of testimony, pages 312 to 316.

A. "I would prefer not to use the term market value, because that fluctuates. Let's use the term fair value, which, I might say, might be defined as the average market value over a considerable period of time in order to wash out the speculative fluctuations in price which occur from time to time. I think there is a central line which passes through the long term price fluctuation of a stock and which represents a figure pretty close to the intrinsic value of the stock. In my own thinking, I think of that in terms of a leveled average of the market price in order to wash out the effect of violent speculative movements upwards and downward.

Q. "Taking that term as you defined it, what relationship does that have, if any, to book value?

A. "Well, I find that it has very little relationship, if you mean by relationship comparative value. I would like to cite several cases, if I may.

"In 1928 the book value of Pennsylvania Railroad stock, for example, was about $86 a share, and the market value ranged between $62 and $77. There seemed to be some reasonable relationship there. Since that time and up to 1954 the Pennsylvania Railroad has plowed back earnings of over $20 a share into surplus, bringing the book value well over $100 a share. However, during that same period the average market value steadily declined, and last year, 1954, it ranged between $15 and $25, an average price of $20. It seems clear that book value and market value do not quite relate. The reasons for it, I think, are clear. It is due to the obsolescence of the Pennsylvania Railroad or the eastern railroad industry as a whole, and that in turn is due to the competitive elements in transportation, such as air lines, trucks, buses and so forth.

"We find much the same sort of trend in F. W. Woolworth Company in recent years, although not quite so pronounced. The book value in the last 15 years has increased by 55% while the earning power remains constant and the market value has declined. Again the book value goes up and the median value in terms of average market price declines.

"In the case of Standard Oil of New Jersey there is a different picture. The book value in the past 20 years has trebled from 20 to 60 (adjusted to reflect capital changes including stock dividends). The price, however, in the same period has risen much more rapidly than the book value from an average of approximately 20 about 15 years ago and is now up to 111 as of the other day when I looked at the paper. Its trend in this case is in the same direction as book value but it has moved much more rapidly. This is easily explained, I think, by the fact that Standard Oil of New Jersey has been able to invest and re-invest its capital at rising rates of return due to faorable economic climate in the oil industry. The average return on book value of Standard Oil of New Jersey in terms of its reported earning power during the 1935 to 1939 period was of the order of 7% per annum; whereas in recent years it has been of the order of 16%. In this case average market value has risen much more rapidly than book value for reasons which bear little or no relation to book value.

Q. "Would you say that book value is of no consideration in the determination of what you refer to as the average market value?

A. "It is of course a consideration in the determination of the reasonable value of a stock. I think it is a minor consideration compared with such things as the average level of earnings and dividends and more importantly the prospective average level of earnings and dividends. I find the book value most useful as a tool of analysis rather than a figure which has any specific meaning in and of itself." [41]

Testimony of Paul C. Wagner:

"As I said, I believe the rule assumed that the proceeds of the sale of common stocks include in dollar amount the increase in dollars per share shown in the Earned Surplus or Undistributed Earnings Account, and the formula also assumed that this is the first amount to be taken out of the sales price. No attempt is made to ascertain how much of the sales price may be due to the increase in the capital accounts, and it seems to me at this point the discrepancy between theory and reality becomes apparent, especially to the investment specialist and the accountant.

"In my opinion, the purchaser of common stocks buys an interest in a growing concern. He does not buy a fractional interest in specific items of real, personal and intangible property and in cash, represented by entries on the assets side of the balance sheet nor a fractional interest in those entries on the liability side which represent book value. In making his purchase, he considers, among other things, the current value of the corporation's assets, the quality of its management, the character of its product, and an informed estimate of its prospects. I have not included in this listing the important psychological factors which influence stock prices, although they have a profound effect upon the final results of apportionment as they benefit or prejudice the respective interests of the life tenant and remaindermen, because frequently it is these features which result in the great variations in market price.

[41] Notes of testimony, pages 215 to 218.

"To illustrate these statements, the following facts relative to Standard Oil of New Jersey stock may be of value.

"During 1930, the year in which Mrs. Ketterlinus died, the market price varied from a high of 84 on April 30 to a low of 44 on December 17th. On December 31, 1929, the book value was $46.60. On December 31, 1930, it was $46.55. During that year there was an increase in the Earned Surplus Account of slightly more than one-tenth of 1c per share. The figures relating to book value and Earned Surplus are based upon the figures in the company's annual reports, without any adjustment whatever. In practically every year since 1930 there were adjustments in the Earned Surplus Account, not relating to operating earnings for the year, of sufficient amount and importance to have been noted in the Studley-Shupert Analytical Review.

"It was not until 1948, the year in which the large block of Standard Oil of New Jersey stock was sold, that the market price again reached 84, the high price in 1930. In that year the low was 70 and the high was 92. The Ketterlinus stock was sold at prices varying from 77½ to 90⅜ during the period from May 25 to August 16. The average price was 81½. The book value had increased from 46.55 as of December 31, 1930, to 67.35 as of December 31, 1947, and 74.78 on December 31, 1948 after the issuance of stock dividends totaling 5% in 1948. The increase in the Earned Surplus Account between December 31, 1930, and December 31, 1947, was $19.07 per share, with an additional increase of $7.10 per share between December 31, 1947, and December 31, 1948. As of December 31, 1954, the book value was $131.85, the market value was $221.25, and the increase in the Earned Surplus Account from December 31, 1948, was $51.60 per share. The market value on May 20, 1955, was $225.50, the high in 1955 having been $239.75. The figures which I have just used for 1954 and 1955 are twice the actual figures, this adjustment having been necessary for comparative purposes because of a two for one stock split in 1951.

Q. "Mr. Wagner, at this point I would like to direct your attention to the precise problem before us in this case. According to the stipulation which the parties have entered into, from the date of death in 1930 to the time of the sales in 1948 the market price of Standard Oil of New Jersey went from 68.62½ to 81.50, the latter figure being the average sale price over the period during which the shares in question were sold. During the same period book value went up from an adjusted figure of 45.52 to 70.01. In your opinion, was this increase in market price caused by the increase in book value?

A. "No, it was caused by the factors I referred to before as being the factors which I believe influence the market value of a stock. Book value can be related only to the current value of the corporation's assets, and therefore an increase in the current value of the corporation's assets is certainly a factor with respect to the market price, but I do not believe that the increase in the current value of the corporation's assets had any relation to the increase in the book value, and therefore I do not think it had any direct relation to the increase in market value." [42]

Testimony of Brandon Barringer:

"It [the *Rule in Nirdlinger's Estate*] is illogical because the profit on the sale of a security bears very little relationship to an increase in its book value. Book value itself, to the extent it means anything, usually is an indication—and a very poor one at that—of what it would cost a competitor to go into business. The value of a stock, however, depends on the collective judgment of the marketplace as to the future dividends to be received from it, having in mind at the same time comparative values in other securities and also prices which speculators may be paying, or in the future pay, during a period of speculative excitement. Some companies such as Minneapolis-Honeywell and DuPont are today selling for prices which value their plants at many times their book values. These prices obviously have no relationship to such book values and any further increase in the book values will have a negligible effect on whatever the future prices at which they sell may be." [43]

Testimony of Robert W. Williams:

Q. "As a reason for apportioning gains on sales of stock an analogy has been drawn between the realization of accumulated earnings on a corporate liquidation and the realization of accumulated earnings on a sale by a trustee of a share of stock in a going concern.

A. "The trustee who sells his shares of stock in a public corporation does not thereby realize any allocation to him of any previously undistributed earnings of the corporation. He just realizes what the purchaser of his shares appraises to be the fair measure of the future earning power of the business.

". . . .

"To my mind as an accountant—and I think financial analysts and traders in securities would agree with me—there is no relationship between the market value and the book value. One was not related to the other. It was not at the beginning of this trust and it was not at the date of sale. It is fantastic to me

[42] Notes of testimony, pages 277 to 281.
[43] Notes of testimony, pages 190 to 191.

to reason that the selling price included with respect to the seller any measure of realization of something which he might or should have had during the term of the holding of this block of stock." [44]

To this argument the expert witness for the life tenant answered:

Testimony of Edward Hopkinson, Jr., Esq.:

"Although it is true that book value alone did not necessarily determine the market value of the shares of Standard Oil Company of New Jersey sold in this account in 1948 or 1951, nevertheless the reinvestment of the retained earnings of this company, reflected in the increased book value, was reasonably to be expected to lead to further increased earnings and dividends and did favorably affect the market value of the shares of stock sold by the trustees in 1948 and 1951.

". . . .

"In my opinion, the above actual dollar amounts of accumulated undistributed earnings are only the minimum amounts reflected in the proceeds of sale of the aforesaid shares with respect to such accumulated earnings. It must be recalled that those sums of retained undistributed earnings were reinvested in the properties of the Company over a period of years at a generally lower price level than that prevailing at the time of the sales in 1948 and 1951. Retained earnings of a company are not segregated in a separate pocket or account but are immediately mingled with all the other cash resources of the company. Therefore, property acquired by the Company over such period of years was, of course, purchased, in part, with those retained earnings and, in part, with the Company's other cash resources, both being inextricably mingled. The general increase in value occurring over the period was necessarily the result, in part, of the use of such retained earnings." [45]

In conclusion, the problem presented in *Ketterlinus Estate* can best be summarized by saying that if and when the Supreme Court of Pennsylvania is again asked to pass on the *Rule of Nirdlinger's Estate,*[46] it will be faced with

[44] Notes of testimony, pages 298 to 301.

[45] Notes of testimony, pages 322 to 324.

[46] The Supreme Court reaffirmed the *Rule in Nirdlinger's Estate* most recently in *Cunningham Estate,* 395 Pa. 1, 149 A.2d 72 (1959), by dicta. There it held that apportionment should be restricted to four specific situations under the *Pennsylvania Rule:* (1) the distribution by the corporation of an extraordinary cash or stock dividend, (2) the liquidation of the corporation, (3) *a sale of the stock by the trustee,* and (4) the issuance of stock rights. *Cunningham Estate* itself involved the apportionment of a "stock split" supported in part by a capitalization of earnings; See 63 DICK. L. REV. 276 (1959).

a choice of two alternatives as it was in 1927. Either it must choose to follow the motivating policy behind the *Pennsylvania Rule of Apportionment,* that of achieving the most equitable apportionment at the expense of administration difficulty; or it must choose to ease the burden of administration at the expense of achieving the most equitable apportionment. Which path the court will ultimately decide to follow is purely a matter of speculation, but until it chooses one of them, the trustee must continue to treat the sale of stock from a trust created prior to 1945 as an apportionable event. As to what part of the proceeds of the sale must be retained in the corpus and what part belongs to the life tenant, the trustee's only resort to immunize himself from possible personal liability from a faulty distribution is to seek the refuge of an orphans' court accounting.

PHILIP C. HERR, II.